Chapter 6

IMPLEMENTING A VALUE-ADDED TAX IN CERTAIN INDUSTRIES AND ACTIVITIES

I. Introduction

A basic characteristic of a value-added tax is that it functions most effectively if it is applied uniformly throughout the entire economy. Yet this may not be possible with some forms of activity. The application of a value-added tax to the typical manufacturing, wholesale, and retailing business is conceptually clear cut, although some questions may arise about incidental issues, such as fringe benefits to employees. In the case of other types of economic activity, however, such as banking or farming, or with other organizations, such as governmental or nonprofit entities, a value-added tax encounters difficult questions of principle and of implementation. These issues are discussed in this chapter in the context of a consumption-type value-added tax with tax liability determined under the credit method.

II. Taxation of Services

A value-added tax is designed to be a general consumption levy on all consumer expenditures. Accordingly, expenditures by consumers on services, as well as those on commodities, should be subject to tax. The failure to tax expenditures on services would favor those persons with relatively strong preferences for services, distort consumption away from commodities and toward services, and substantially reduce the tax revenue available at a given tax rate. Moreover, the taxation of all expenditures on consumer services would make the value-added tax less regressive. Many, but not all, services are covered under the European value-added taxes; most states, however, tax only a limited range of consumer services under their retail sales taxes. Only Hawaii, New Mexico, and South Dakota include most services in the bases of their retail sales taxes.

One major advantage of the value-added tax over the retail sales tax with regard to services is the ability to exclude from tax services rendered to business firms through the tax and credit mechanism; services provided to businesses are subject to value-added tax, but the business purchasing the services may credit this tax against the value-added tax due on its sales. In effect, this tax and credit procedure frees services provided to business customers from the value-added tax until they are reflected in the retail sale of a good or service. State retail sales taxes do not routinely exclude all services provided to businesses. If these services are taxed, business firms are given an incentive to provide the services with their own employees, rather than to obtain them from firms that specialize in providing services.

In considering the value-added taxation of services, various problems are encountered which make it doubtful that the value-added tax could be comprehensively applied to all services. For one thing, the control of service establishments for tax purposes is generally more difficult than the control of those selling commodities because the relationship between purchases of produced goods and sales is relatively weak. Accordingly, it is more difficult to ascertain the correct sales volume of service establishments by reference to their purchases. Because many service establishments are relatively small, the control function of tax administrators is both difficult and time consuming.

A. Services Clearly Suitable for Taxation

Several groups of services provided to consumers are clearly suitable for inclusion within the scope of a value-added tax:

1. Public utility services, such as electricity, gas, telephone, telex, cable, and probably water service. These services are provided by large firms or governmental units that are easy to control. There is no inherent objection to taxing these services, though some questions may be raised about value-added taxation of water because of its "necessary" aspect. If food is zero rated, water probably should be as well.

2. Services rendered by commercial establishments, many of which also sell commodities. Thus, repair services, such as for motor vehicles, fabrication activities of all types, barber and beauty parlor services, and laundry and dry cleaning services, would all be taxed. Including these services in the value-added tax would facilitate administration and compliance, since these firms would not need to segregate their sales of commodities from their providing of services, as they now must do under most state retail sales taxes.

3. Amusement and entertainment services of all forms, including social, golf, health, and racquet clubs.

4. Hotels, motels, other transient accommodations, and restaurant meals. If residential housing rentals are not taxed, a somewhat arbitrary line must be drawn between personal housing and transient rental accommodations, probably based on the length of stay.

5. Rental of taxable durable commodities, such as motor vehicles, video tapes, tools, and appliances. The rental firms would pay tax on its purchases of these goods and receive credit for the tax against the tax charged on the rentals.

6. Bookkeeping, accounting, legal, consulting, engineering, architectural, and related services. As with other services, business firms acquiring these services would receive credit for tax paid on the services against tax due on their sales.

B. Financial Services

Under the income tax, taxation of financial institutions presents complex and troublesome issues for both the government and the institutions; the problems involved in the tax treatment of financial activities under the value-added tax are also formidable.

On the one hand, value added in banking, thrift, and insurance activities is no less appropriate for inclusion in the value-added tax base than value added in, say, manufacturing. As explained in the previous chapter, there also are good reasons why both financial institutions and their business customers may favor the full inclusion of financial institutions in the value-added tax system. Nevertheless, the practical problems of taxing financial services have led all European Economic Community (EEC) countries to exempt the basic lending activities of banking, insurance, and related financial establishments from the value-added tax.

1. Banking and related institutions. In the manufacture and distribution of commodities and many other services, identifying "value added" is a relatively straightforward exercise. Particular problems, however, arise with respect to banks, savings and loan associations, and similar institutions.

Banks, in their basic or core activities, are essentially "renters" of money. They "rent" from their depositors, to whom they pay interest (or provide free checking accounts), they (at least the commercial banks) "create" money through credit expansion, and they "rent out" money to borrowers, for which they receive interest, either directly or through the purchase of securities. The value added by banks and other financial institutions is basically the difference between what the banks pay their depositors and the amount received from their loans and investments. If their depositors were solely business firms already registered for the value-added tax, the banks could be charged tax on interest paid to these depositors; the banks, in turn, would apply the value-added tax to their "sales", that is, to the interest received on their loans, and receive credit for the tax paid to their "suppliers" or depositors. In this case, there would be little difference from the way the value-added tax applies to manufacturers or distributors.

There are, however, several complicating factors.

Many of the banks' depositors are not business firms but individuals with savings or time deposit accounts. Since these non-business depositors would not be registered taxpayers, the banks would not be charged value-added tax on the interest paid to non-business depositors. To require the business depositors to charge and remit value-added tax when individual depositors did not could easily create confusion for the bank and the various classes of of depositors. An individual, for example, would be treated differently depending on whether the deposit account was for "business" or "private" purposes.

Furthermore, the banks' depositors often do not receive a market rate of interest, but various bank services instead, such as checking accounts.

In general, therefore, it would not be desirable to attempt to apply the value-added tax to depositors in financial institutions. As a consequence, banks would have no value-added tax on interest paid on their deposits to credit against the value-added tax due on the interest they would charge on their loans. In itself, this is not a serious matter; the banks would simply be remitting value-added tax on the value added both by themselves and their depositors. Thus, one general alternative for the treatment of banks and similar institutions would be to apply value-added tax to the interest they charge their borrowers on new loans. (To apply value-added tax to existing loans would cause the banks to suffer windfall losses.) Various questions can be raised, however, about doing so. They may be considered in reference to the major classes of borrowers.

(a) Business borrowers. A substantial portion of bank lending is to business firms, who would be charged value-added tax on the interest paid to the bank. These business firms, if they are registered taxpayers, would receive credit for the value-added tax paid to the bank against the tax due on their sales. It would not be necessary to require banks to charge value-added tax on interest received with respect to the bank's holdings of corporate bonds. The corporation which issued the bond would not pay tax on its interest payments; nor would it receive any credit for tax not paid.

(b) Farmers. Under a proposal made in another section to this chapter, farmers would not be registered for the value-added tax. If farmers were not registered taxpayers, they could not obtain credit for any value-added tax paid on interest charged on their borrowing. To avoid any cascading of value-added tax, it would be necessary to eliminate the tax on the farmers' "purchases." Accordingly, just as the purchases by farmers of feed, seed, fertilizer, and farm machinery would be free of value-added tax, interest paid by farmers on the money which they borrow should be excluded from the tax.

(c) Governments. Most, but not all, of the lending to governments occurs through the purchase of long and short term debt securities. The question is whether value-added tax should be charged on the interest paid on government bonds. Ideally, one could argue that tax should be charged so that government and private borrowers pay similar costs. Charging value-added tax on private, but not government, borrowing may be viewed as subsidizing government borrowing. State and local governments, however, may object to the imposition of a Federal value-added tax on their borrowing costs as a revenue transfer from sub-Federal governmental units to the Federal government. Thus, there may be pressure to exclude borrowing by state and local governments from the value-added tax.

(d) Consumption loans. Loans to consumers are essentially a consumption expenditure that enable persons to consume sooner than otherwise. Accordingly, in principle, interest on these loans should be subject to value-added tax, along with all interest charges made by sellers to customers buying on credit. However, a closer look at the issue suggests some problems. Consumer credit can be grouped into two major classes.

(i) Housing loans. A substantial portion of all household loans is for housing construction and purchase. As discussed in another section to this chapter, there is merit, from an equity standpoint, in avoiding a heavy value-added tax burden on housing. It may be viewed as unacceptable to add a value-added tax to interest paid on home mortgages.

(ii) Other loans. Most other loans, in dollar amounts, are made for purchases of consumer durables. The value-added tax should apply to the interest on these loans since they are for consumption expenditures. Some retail sellers frequently include a carrying or finance charge in their sales prices, in effect, offering liberal payment terms in exchange for a higher price. Since the full sales price would be subject to value-added tax, the failure to tax interest on consumer loans would discriminate against this category of retailers. The alternative of requiring the retailer to separate the finance portion of the charge from the basic sales prices of the goods would be a major complication.

Some consumer loans are truly for hardship purposes, such as when a sudden loss of income or increase in emergency expenses (e.g., illness) requires one to borrow. Delineation of these from other consumer loans is virtually impossible, but their existence raises some doubt about the general desirability of taxing interest on consumer loans.

Taxation of interest on consumer loans, when that on other loans is not taxed, would give rise to some borderline problems. A farmer may borrow to improve both his barn and his house. Individuals may borrow to buy securities. Some dividing lines can be developed, but not without administrative complications.

A final problem with regard to taxing consumer loans by banks is the incentive that would be given to persons to borrow for consumption purposes from sources other than banks and other registered financial institutions. It may be possible to use income tax records to ensure that value-added tax is paid on loans from one individual to another. This, however, may greatly increase the number of value-added taxpayers. The problem is somewhat parallel to the problem of casual purchases of goods from other individuals, but there would appear to be substantially greater opportunity for this type of substitution of loans than for the purchase of goods.

(e) International complications. If application of a value-added tax to financial institutions is limited to interest on consumer loans, there should be no significant international complications. Interest paid by foreign borrowers would not be subject to value-added tax under the destination principle. Borrowing by U.S. consumers from foreign banks would technically be subject to tax and probably could be reached by treaty arrangements.

(f) Summary. For the basic or core lending activities of banking and of other thrift institutions, there are three major options, the third being the closest to the European system, which generally exempts financial institutions:

(i) Apply value-added tax to interest charged on all loans. The value-added tax would be a credit for registered business firms against their own value-added tax liability. Though this approach would subject consumer loans to value-added tax, it would also impose a value-added tax on housing loans, as well as farm and government borrowing; there are, as noted, objections to taxing these types of loans.

(ii) Apply value-added tax to interest charged on all loans, but zero-rate interest charges on loans to government, farming, and housing to avoid imposing additional tax on these sectors.

(iii) Apply value-added tax to interest charged only on consumer loans, but exclude interest charged on housing loans. All other loan interest would be exempt, not zero rated. Under this approach, banks would be treated as exempt on all of their lending activities, except for consumer loans. The primary objection to this approach is that banks and other financial institutions would have to distinguish between consumption loans and other loans. Ideally, they also would have to segregate their purchases related to taxable consumer loans from those related to their exempt lending activities.

As distinct from their core banking functions, financial institutions also perform various services for which a specific charge is made. Some services such as checking accounts with above-minimum specified balances are provided free of direct charge, being financed by the interest earnings on the depositor's money. But others are subject to a direct charge: rentals of safe deposit boxes, provision of printed checks, and brokerage activities. These services can and should be taxable. If most interest charges are exempt, the institutions would still be registered for their secondary activities. Establishments rendering taxable financial services would be able to credit value-added tax paid on purchases of material and equipment against taxes due on charges for brokerage, safety deposit boxes, trust functions, and other secondary activities, to the extent that the materials and purchases can be attributed to these secondary activities. This should not be a difficult procedure for the banks since many of these purchases, such as checks or safe deposit boxes, are directly related to the services provided.

2. **Brokerage activities.** There is a wide range of brokerage services, involving the sale of securities, real estate, and the like. These can be subject to a value-added tax, but the argument may be raised that taxing them would interfere with the free functioning of capital markets and that these services, such as for the purchase of securities, are not truly a consumption expenditure.

3. **Insurance.** The value added of an insurance company is roughly equivalent to the payments it receives from policyholders for risk protection. In the case of a term life insurance policy, which has no, or minimal, savings element, value added is approximately equal to premium receipts less death benefits paid. For a life insurance policy with a cash value, value added would be equal to premium receipts less death benefits and the policy's savings component. Value added for other forms of insurance, such as automobile and health protection, also would be equal to premium receipts less claims paid.

Ideally, a broad base value-added tax could be applied to the value added of an insurance company. However, the credit method value-added tax does not lend itself readily to insurance company taxation. Though the company could certainly charge value-added tax on its premium receipts, it presumably would not be charged value-added tax by policyholders on amounts received as claims paid. The insurance company could possibly act as the withholding agent, but there may be substantial public opposition to imposing a value-added tax on amounts received on death benefits or health insurance claims. For the insurance industry, a subtraction type value-added tax may be preferable to the credit method value-added tax, but this, of course, would be a substantial departure from the basic credit method system that is the focus of this volume. As a second-best alternative, exemption of insurance companies may be the soundest policy choice.

All Member States of the EEC exempt insurance transactions, as allowed by the Sixth Directive. Thus, insurance companies are not taxed on the delivery of insurance services, nor are they allowed to deduct value-added tax imposed on purchases related to the delivery of those services. The effects of exempting insurance would be parallel those in the banking and finance area. Though exempt persons and final consumers would benefit from buying insurance on an exempt basis, the impact on taxable persons may be adverse because of the multiple taxation problem created by not allowing the insurance firm a credit for the tax paid on its purchases. Still, given the difficulty of measuring value-added in the insurance industry, at least in the context of a credit method value-added tax, the best alternative may be to exempt, but not zero rate, insurance activities.

C. Governmental Activities for Which No Charge Is Made

Most governmental activities are financed through taxation, without a specific charge being made to the user of the service. Because of the absence of a price for most government services, the value-added tax cannot be applied in the usual fashion to traditional

government activities. The tax treatment of sales of certain commodities and services by governmental entities as well as of sales to Federal, state, and local governments will be discussed in a separate section.

D. Services That Cannot Effectively Be Taxed for Administrative Reasons

Some services would be suitable for value-added taxation, but they cannot be taxed for administrative reasons. These include:

1. Foreign travel. A value-added tax should not be imposed on expenditures for travel outside the country. The taxation of airline tickets for overseas travel would distort consumer buying habits and cause American carriers to lose passenger traffic; many U.S. travellers would simply buy a ticket to the nearest Canadian city and then purchase a ticket in Canada for the remainder of the trip.

2. Personal service rendered in the home by individual employees. There is no feasible way of including this service within the scope of the value-added tax, whether the persons are technically employees (and thus legally subject to social security withholding) or independent contractors, but not established firms. Payments to individuals providing household cleaning, babysitting, and lawn and garden services cannot be taxed, except when they are made to commercial establishments with a fixed place of business. Some economic distortion and inequity would result from failing to tax these services, but there is no ideal workable solution. A closely-related problem is the widespread "moonlighting" activity in home repair, painting, and plumbing by persons who are employees of commercial firms, but who also provide these services on their own time.

E. Problems in the Transportation Field

Some problems would arise in applying a value-added tax to transport services. Some forms of transportation are highly competitive with the "do-it-yourself" provision of transport service; the labor component of the latter cannot be fully taxed. Other transport is highly subsidized by the government. The application of a value-added tax to a subsidized service is likely to increase the government subsidy with no net revenue consequences.

1. Freight transport. There is little justification for taxing freight transport under a single-stage retail sales tax of the type used by the states since it is rendered almost exclusively to business firms. But a value-added tax should be applied to freight transport since the transport firms would then receive a credit for the tax paid on their purchases of equipment, supplies, and fuel. Business customers would receive credit for the tax paid on their purchases of freight transport. If transport firms were not subject to value-added tax they would not receive a credit on their purchases and there would be a break in the tax and credit chain. But even with a value-added tax there are some problems.

Consider the purchase of transport service by an organization that is exempt, not zero rated. Since an exempt entity cannot obtain a credit for tax paid on its purchases, the cost of for-hire transport would be increased compared to private transport provided by the exempt entity itself. As with the purchase of any good or service by an exempt entity, this would give the exempt firm an incentive to provide its own freight transport service.

Another problem in freight transport arises out of the large number of owner-operator truckers, as many as 100,000. Those who work under contract for common carriers do not need to be registered from a collection standpoint, since their receipts would be included in the charge made by the common carrier to the customer. If they are not registered, however, they cannot receive a credit for the value-added tax paid on their purchases. One solution, which would avoid registering these owner-operators, would be to allow the common carriers for which they operate to take the credit for the value-added tax paid by the owner-operators on their purchases. This, however, would require the owner-operators to maintain the records necessary to document the purchase credits taken by the common carriers.

On the whole, the application of the value-added tax to freight transport would involve a number of administrative difficulties, but these do not amount to a compelling reason for excluding transport firms from the coverage of tax.

2. **Urban passenger transport.** Most urban transport is provided either by governmental agencies (transit authorities) or by private firms under contract. In either event, there is a substantial subsidy element; with some transit systems no more than a quarter of the revenue comes from passenger fares. If a value-added tax were applied to the fares, either the fare net of tax would be reduced to avoid the loss of passenger traffic, or, if the fare were increased by the amount of the tax, passenger traffic would fall. In either event, the required subsidy would be greater. There is nothing inherently wrong with this in an economic sense, although it would result in a revenue transfer from local governments to the Federal government. To the extent that encouraging the use of urban transit to alleviate street and road congestion and pollution is considered an important social objective, a case can be made for zero rating urban transit, including metropolitan area rail and bus commuter service.

The issue of taxi service is more complex. It is tempting to think of taxis as being used primarily by higher income consumers, but some of the users are poor and others are business users. Many taxis are owner-operated, and it may be difficult to monitor them for tax administration purposes. Since zero rating of taxis would pave the way for abuse in the purchase and use of motor fuel and vehicles, exemption is the best solution.

3. **Intercity passenger service.** This type of service should be subject to value-added taxation. The arguments for alleviating road congestion and air pollution apply with much less force than in the

case of urban-area transport. Like urban transport, some of this transportation, such as that provided by AMTRAK, is also subsidized. But AMTRAK provides freight service as well as passenger transport. Exempting AMTRAK probably would not be acceptable to AMTRAK's business customers who purchase freight service. Zero rating, on the other hand, would be overly generous given the differences with urban transport. Air transport, as well as train service, should be subject to value-added taxation.

Travel agencies constitute a special form of broker, but one that does not charge the customer for its services, which instead are paid for by the carrier out of ticket fares. Most of the services of travel agents relate to air transport; if air transport is taxed, the travel agency service would be included in the value-added tax base through the taxation of airline fares. The agency could only receive credit for value-added tax paid on its purchases if it registers. As a selling agent it would apply the value-added tax to the charge for the tickets, but this would be remitted to the airline, which would pay it to the IRS.

F. Services Involving Significant Social Policy Considerations

A significant portion of total expenditures on services, about 17 percent, are made for medical, dental, hospital, and related health services. Full value-added taxation of these services would be unlikely as a matter of social policy. Exempting the providers of these services, rather than zero rating the services, would place some tax on the services, but less on those that are labor intensive. Exempt entities would not need to file value-added tax returns. Zero rating would remove the burden of the tax entirely. The case for zero rating is probably stronger for hospitals than for the professional services themselves, as purchases are a more significant element in the total cost of hospital than of physicians' services. Differential treatment, however, may encourage the provisions of physicians' services in the hospital, where they would be zero rated, rather than in an office setting where they presumably would be exempt.

Some of the same considerations apply to legal services. Business firms would, of course, receive credit for value-added tax paid on these services against the tax due on their sales; the portion on individuals would rest upon the persons acquiring the services. There may be some objection that value-added taxation would interfere with the attainment of justice by making it more expensive. The case for exempting or zero rating of legal services, however, is not compelling. A substantial portion of legal work is for strictly consumer activities, such as the preparation of wills and resolution of domestic disputes. Legal services should be subject to value-added taxation.

Education is another type of activity to which application of the value-added tax may be regarded either as impractical or objectionable on social policy grounds. While some portion of private spending on education may represent consumption, some outlays for education can

also be viewed as contributing to human capital formation. Many educational services are provided more or less free of charge by governmental entities. Consequently, either no or a heavily-subsidized price is charged for publicly-provided educational services. Thus, it would be difficult to apply a value-added tax to the true value of these educational services. If public education were not taxed, consumers of private education would object to taxation of the tuition charges, especially since many private schools have religious affiliations, formal or otherwise. The same considerations apply to university education. As a matter of both social and economic policy, tuition charges should not be subject to value-added taxation. If the value-added tax is not imposed on most purchases by state and local governments, education should be zero rated, rather than exempt.

Similar policy issues relate to religious and charitable institutions. For the most part, those organizations do not charge a price for their services and value-added tax cannot be applied. The issue is not one of applying the value-added tax to their "sales," unless they operate incidental commercial activities such as gift shops, but how their purchases should be treated. This issue is considered in the section on nonprofit institutions.

G. Summary

For economic, revenue, and administrative reasons, a value-added tax should apply to as many services as possible. Any departures from this rule would favor those preferring to consume untaxed or lightly-taxed services, require higher tax rates to raise an equivalent amount of revenue, and complicate the administration of the tax. Accordingly, exemptions or zero rating of consumer expenditures on services should be kept to an absolute minimum. The only services which should be exempt or zero rated are those for which a clear and convincing justification is made on either social or administrative grounds.

III. Taxation of Small Enterprises and Farmers

A value added tax, like any sales tax, is collected from business firms. The effective operation of the tax requires that the firms collect the tax accurately from their customers, keep records of taxable sales and purchases and of tax collected on sales and of tax paid on purchases, file correct tax returns on time, and remit the tax to the government. These tasks create no major problems for most typical business firms, though they give rise to some compliance costs. But there are two general types of enterprises that may find compliance with the value-added tax difficult, and, in turn, effective control of them may be difficult. These are small businesses and farmers.

A. Small Businesses

Even in the United States, there are large numbers of small firms. They tend to be heavily concentrated in the service industries. Other vendors have no established places of business: sidewalk sellers,

house-to-house peddlers, housewares distributors operating from their homes, newsboys, and those selling in flea markets, farmers' markets, and the like.

The basic issue is: should such firms be excluded from the coverage of the value-added tax, presumably by exemption? If so, how should the line be drawn between firms that are to be included within the scope of the tax and those to be excluded? One general approach is to exempt those firms with sales below a specified figure; they would not be registered, but tax would apply to sales to them and they would not receive credit for the tax paid on their purchases.

1. **The case for exemption.** The argument for exemption of small firms is based on operational considerations; the concern that such firms would not maintain adequate records of sales and of value-added tax collected on sales and paid on purchases and that they would not file returns accurately, if at all. All of the EEC countries and most other countries using value-added taxes (as well as ones using manufacturers and wholesale sales taxes) do provide exemptions, usually on the basis of annual gross sales. Some of these countries then apply a "forfait" assessment to the small firms, based on external indicators of the likely volume of sales, such as the number of employees. This procedure is completely foreign to U.S. experience. The Sixth Council Directive of the EEC, issued in July 1977, gave the member countries the option of "applying simplified procedures" for small firms, and all have done so. Table 6-1 summarizes treatment of small firms in a number of countries.

Apart from the compliance problems, the task of handling the tax returns, payments, and delinquencies of small firms would be a major one, for a relatively small amount of revenue. As shown in Table 6-2, a $10,000 gross receipts exemption would, on the basis of 1979-80 returns, have excluded over one-half of the sole proprietors and about one-third of the partnerships in the United States from responsibility for the tax, but only 2.5 percent of total receipts. A $25,000 figure would have excluded 70 percent of the proprietorships, and nearly 50 percent of the partnerships, and about 7 percent of sales. As stated in Table 6-2, these figures exclude the farm sector.

2. **Objections to exempting small firms.** From an economic standpoint, exempting small firms in regular production and distribution channels would create economic distortions. Registered taxpayers would be discouraged from buying from exempt firms, but consumers would tend to purchase from such firms. This would be particularly true if small retailers were excluded; they could, if they wished, sell more cheaply to consumers than their registered competitors. There would also be major problems with where to draw the line for exemption, the determination of whether firms fell above or below the line, and the possibility that a firm's tax status would change during the year.

Table 6-1
EXEMPTIONS OF SMALL FIRMS FROM SALES TAXES, BASED ON SALES VOLUME*

Country	Year	Firms Exempt with Annual Sales Under	Exchange Rate May, 1984	Exemption Expressed in U.S. Dollars	Treatment
Value Added Taxes:					
Belgium	1980	Bfr 2.5 million	55.8	44,803	exempt
		2.5-4.5 million		44,803-80,646	equalization tax on supplier
		4.5-15 million		80,646-268,817	forfait
Denmark	1975	kr 5,000	10.05	498	exempt
France	1980	fr 500,000	8.41	59,453	forfait[1]
Germany	1984	DM 20,000	2.735	7,312	exempt
		20,000-60,000		7,312-21,938	digressive scale
Eire	1980	£ 2,000 for 2 months if 90% sales exempt or 10%	.8937	2,238	exempt
		1,000 for 2 months if rate above 10%		1,119	
		300 service and others		336	
Italy	1980	£ 6 million[2]	1687.5	3,557	forfait
Luxembourg	1977	Bfr 100,000	55.8	1,792	exempt
Sweden	1980	kr 10,000	8.08	1,238	exempt
United Kingdom	1980	£ 5,000	.714	7,003	exempt
Argentina	1980	P 36,000,000	41.6	87,591	special tax on purchases
Bolivia	1977	B 200,000	196	1,020	exempt
Costa Rica	1977	C 800,000	41	19,410	exempt
Indonesia[3]	1984	R 24,000,000[4]	982	24,439	exempt
Manufacturers Sales Tax:					
Canada	1984	$C 50,000	1.22	40,983	exempt
Philippines	1983	P 2,400	11	218	exempt
Kenya	1977	Ks 100,000	14.4	6,944	exempt
Zambia	1982	K 10,000	1.35	7,407	exempt
Guyana	1982	G$ 10,000	3	3,333	exempt
Wholesale Sales Taxes:					
Australia	1982	A$ 12,000[5]	1,113	10,782	exempt
New Zealand	1982	NZ$ 5,000	1.54	3,246	exempt
Switzerland	1983	Sfr 35,000	2.26	15,486	exempt
Retail Sales Taxes:					
Zimbabwe	1983	Z$ 20,000	1.05	19,047	exempt
Paraguay	1977	G 1,800,00	126	14,285	tax applies to purchase
States of India[6]	1983	R 10,000 to 50,000	10.22	978-4,892	exempt
Exemption Based on Tax Liability					
France	1980	fr 1,350	8.41	101	exempt
Equivalent sales figure		fr 7,670		912	
Netherland	1980	G 2,050	3.08	665	exempt
Equivalent sales figure		G 11,388		3,697	
Australia-alternate	1982	A 250	1.13	221	exempt

* to appear in Public Finance in the Fall of 1984.
1. Exempt if annual tax under fr 1,350.
2. and all retailers.
3. Tax limited to manufacturing sector.
4. or R 100 million capital
5. or total tax liability under A$250. Exemption applies to manufacturers only.
6. Most are retail sales taxes, 3 are essentially wholesale taxes, 1 is dual point, 4 are cascade (turnover) taxes.

Table 6-2

Distribution of 1979 Nonfarm Sole Proprietorship Returns, 1980 Nonfarm Partnership Returns, and Amounts of Gross Business Receipts by Gross Business Receipts Class

Gross business receipts class	Number of nonfarm returns			Amount of nonfarm gross business receipts		
	Sole proprietorships	Partnerships	Total	Sole proprietorships	Partnerships	Total
	(000s)			($millions)		
Under $10,000	4,984	415	5,399	$ 15,595	$ 1,215	$ 16,810
$ 10,000 - 25,000	1,597	188	1,785	25,956	3,104	29,060
$ 25,000 - 50,000	1,040	168	1,208	37,107	6,047	43,154
$ 50,000 - 100,000	821	167	988	58,357	11,908	70,265
$100,000 and over	901	335	1,236	258,655	244,518	503,173
All Classes	9,344	1,273	10,617	$395,670	$266,792	$662,462
	Percentage Distributions					
Under $10,000	53.3	32.6	50.9	4.0	0.5	2.5
$ 10,000 - 25,000	17.1	14.8	16.8	6.6	1.2	4.4
$ 25,000 - 50,000	11.1	13.2	11.4	9.4	2.3	6.5
$ 50,000 - 100,000	8.8	13.2	9.3	14.7	4.5	10.6
$100,000 and over	9.6	26.3	11.6	65.4	91.7	76.0
All Classes	100.0	100.0	100.0	100.0	100.0	100.0

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Office of Tax Analysis

Sources: Internal Revenue Service, Statistics of Income--1979-1980, Sole Proprietorship Returns, (1982), Table 3, p. 34; and Internal Revenue Service, Statistics of Income--1980, Partnership Returns, (1982), Table 4, p. 33.

NOTE: Details may not add to total because of rounding.

3. **Is exemption necessary?** In the context of the countries of southern Europe and the Third World exemption of small firms is probably imperative, given the large number of small entities with inadequate recordkeeping. But the case for exemption of small firms is not nearly as strong in the United States. Regular retailers, no matter how small, have learned to keep records adequately for complying with income, social security, and state retail sales tax requirements. The states do not exempt small firms, per se, and state tax officials, in general, report that the problem of small firms without adequate records is not significant. In general, the rule used by the states for sales tax purposes is that registration is required if sales are made on a regular basis as an essentially commercial establishment; this rule excludes persons making casual occasional sales (church bazaars or garage sales) and itinerant sellers, such as children selling fund-raising items for school, church, and social organizations.

While regular retail establishments, manufacturers, and wholesale distributors, even if relatively small, can be registered for the tax, there is a need for special treatment of small vendors without established places of business, including the large number of very small providers of services. The most satisfactory manner in which to draw the line appears to be that used by most states: exclude vendors or service establishments that do not have an established place of business or that sell on a casual nonregular basis. Legislative authorization could be given to the IRS along the following lines: Registration shall not be required of those categories of sellers determined not to be engaged in a regular business activity. Under this rule, excluded vendors would be exempt; no tax would be charged on their sale, but value-added tax would apply to the suppliers of these sellers.

4. **Other problems.** If an enterprise that is exempt from the registration requirement sells to registered firms, the tax and credit chain is broken, and the purchaser cannot obtain credit for value-added tax borne on the purchases of the exempt firm. In this case, the option of registering should be given to those enterprises not required to register.

5. **Summary.** No exemption of small firms based on gross receipts or a similar criterion should be provided, but registration for value-added tax purposes should not be required of sellers having no established place of business and making only casual sales.

B. Farmers and Value-Added Taxes

The application of a value-added tax to farmers raises several issues. In general, it is not feasible to simply treat farmers and agricultural products in the same fashion as other segments of the economy. Several aspects of farm production and sale warrant consideration:

1. **The existence of large numbers of small farmers.** While agricultural output has become increasingly concentrated in large farms, there are still many small farms. According to IRS data drawn from the Statistics of Income, as shown in Table 6-3, in the 1979-81 period, of 3.2 million farmers, 2.2 million had gross receipts from farming under $25,000 a year. While these small farmers must keep some records for income tax purposes, they are not subject to state sales taxes, and their records may not be adequate to file accurate value-added tax returns. Compliance costs to farmers of filing periodic value-added tax returns and of making payments would be non-trivial. Moreover, farmers would need to issue invoices to the purchasers of their products, which they may not now regularly do. The administrative costs to the IRS of handling all of these small returns, equal to at least 10 percent of total returns, would be no less significant than the additional compliance costs for farmers.

2. **Exports.** A large portion of total agricultural output, about 90 percent, consists of food, including livestock feed. A high percentage of farm output, about 30 percent overall, is exported. For major crops, the percentages exported in 1981 were wheat, 64; corn, 27; soybeans, 45; cotton, 44; and tobacco, 32. Taxation at the farm level of crops that will be exported involves no net revenue gain and substantial effort; it is not necessary to apply the value-added tax to the sale of a trainload of corn that is destined for export since the tax would be refunded when the farm products are exported.

3. **Solutions.** The application of a value-added tax to agriculture would result in large numbers of small farmers being required to file value-added tax returns, with little net revenue gain. The IRS would incur substantial costs in handling these returns. There are several possible solutions:

(a) Exempt small farmers, those with gross receipts less than a specific amount. This would lessen the problems of compliance by small farmers and the handling of large numbers of low tax returns by the IRS. But the problem of shifting of the tax borne by these small sellers on their purchased inputs would remain. Any borderline based on gross receipts would be arbitrary and firms would not know their tax status until the end of the year. Almost of necessity, the use of the previous year receipts figures would have to be sanctioned. There would be a small incentive to divide farms among family members to avoid having to file tax returns. Small farmers would be favored over larger ones on direct sales to consumers, but business purchasers would prefer to buy from larger registered farmers, who, by virtue of being registered, would get a credit for tax paid on their purchases of farm inputs.

(b) Exempt all farmers from the value-added tax. This alternative would eliminate the borderline between large and small firms; no farmers would need to register or to file returns (unless they sold taxable farm products at retail in an organized, continuous fashion). But the tax and credit chain would be broken for all farmers; farmers could not obtain credit for tax on their farm inputs. Thus, the tax

Table 6-3

FARM ENTERPRISES: Proprietorships, Partnerships, and Corporations
Number and Busines Receipts by Size of Receipts

Gross Business Receipts Class	NUMBER				GROSS BUSINESS RECEIPTS			
	Pro-prietor-ships	Partner-ships	Corpora-tions a/	Total	Pro-prietor-ships	Partner-ships	Corpora-tions a/	Total
	thousands				$millions			
Under $25,000	2,178	36	19	2,223	$13,720	$ 310	$ 112	$ 14,142
$25,000 - 50,000	342	14	7	363	12,262	503	271	13,036
$50,000 - 100,000	247	17	10	274	17,387	1,306	714	19,407
$100,000 or over	204	41	49	294	51,309	17,054	59,810	128,173
Total	2,972	108	85	3,165	$94,679	$19,174	$60,907	$174,760

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Office of Tax Analysis

September 10, 1984

a/ Corporate data are for the "agriculture, forestry, and fishing" industry. Separate figures for farms are not available.

Sources: Internal Revenue Service, Statistics of Income -- 1980 Partnerships Returns, Table 4, p. 33; Statistics of Income -- 1979-1980 Sole Proprietorships Returns, Table 11, p. 165; and Statistics of Incoem -- 1981 Corporation Income Tax Returns, Table 7, p. 49.

NOTE: Details may not add to totals because of rounding.

on farm inputs would be reflected in farm product prices. One solution that is widely used in Europe would allow the purchasers of farm products to presume that a specified percentage of the purchase prices of farm products consists of value-added tax on purchases by the farmer. But the average figure authorized by law would not equal the actual figure for many transactions.

There are other partial solutions to the tax on inputs problem that arises if farmers are exempt. Farmers could be given the option to register if they wished; the experience in Europe is that many of the larger farmers would register. But this does not solve the problem completely. If most farmers register, then the objective of minimizing the number of small returns would not be attained.

Another possible solution is to allow farmers a credit against their income tax liability for value-added tax paid on purchases. But this would complicate the income tax returns and may give farmers a temptation to overstate the credit. Very small farmers not now filing income tax returns would not get the credit without filing a return.

(c) Zero rating farmers. The zero rating of farmers would solve the problem of the tax on farm inputs, but it would require registration of farmers and the filing of returns to receive a refund of the taxes on purchased inputs. This alternative would accomplish little in the way of avoiding costly compliance work for farmers and additional administrative responsibilities for the IRS.

(d) Exempting farmers and zero rating sales to farmers. The fourth alternative is to exempt farmers and zero rate sales to farmers of major classes of farm inputs: livestock and livestock feed, fertilizer, farm machinery, and possibly fuel for farm use. This approach would remove almost all value-added taxes on farm inputs; to also zero rate sales of minor items such as hand tools would pave the way for evasion (consumption use of the item) and create additional complexity. For those categories that are zero rated when sold to farmers, the suppliers would have to distinguish farm from nonfarm sales. But most of the sales of these classes of commodities, other than fuel, are made to farmers; the trade is highly specialized. Fertilizer sold in small quantities through retail stores, for example, would not be subject to the zero rating. Inevitably there would be some leakage, as a farmer used farm fertilizer for his lawn, but this is a minor problem. Zero rating of fuel for farm use may pose more of an abuse problem. Sellers of zero-rated farm inputs would receive credit for value-added tax paid on their purchases of the inputs.

This solution would avoid applying the value-added tax on the sale by the farmer of crops destined for export. Without some special rule, tax would apply on the sale by the country elevator to the subterminal or river elevator, and by the latter to the exporting firm. But it should be possible to devise some form of licensing system that would permit these transactions destined for export to be free of application of the tax.

5. Illustration of alternative approaches. Table 6-4 illustrates four alternative methods for dealing with the problem of farmers: full taxation; exemption; use of the EEC system of allowing the firm purchasing the farm products to treat a specific percentage of the purchase price as consisting of value-added tax on farm inputs; and exemption of the farmer with zero rating of sales to farmers of major farm inputs. The table is based on the assumptions that the farmer can directly add the tax to his selling prices and that food is taxable.

The top section of the table illustrates ordinary value-added tax treatment under a 10 percent value-added tax that applies to a farm supplier, a farmer, and a food wholesaler. In the example, total value added by these firms is $2,000, which at a 10 percent rate would yield $200 of value-added tax revenue.

The second section of Table 6-4 illustrates the situation if the farmer is simply exempt from the value-added tax. The wholesaler cannot claim any credit for the value-added tax included in the purchases from the farmer (there is a break in the chain of credits) and the government actually collects more value-added tax ($60 more in this case) than in the ordinary situation shown at the top of Table 6-4. This occurs because the value added by the farmer's supplier, the seed seller, is, in effect, taxed twice.

The third section of Table 6-4 illustrates how the EEC alternative treatment for farmers would operate. As is shown, the farmer charges no tax on sales and receives no credit for value-added tax paid on seed purchases (or purchases of any other inputs). The wholesaler pays a gross value-added tax of $250 on its sales and then subtracts both the actual and assumed value-added tax paid on purchased inputs. In the example, it is assumed that the wholesaler is allowed to deduct 4 percent of the value of purchases from the farmer from its gross value-added tax liability or $40; the wholesaler also subtracts $50 of value-added tax actually paid on other purchases. Using these assumptions, the wholesaler's net value-added tax would be $160. The total value-added tax collected by the government, in this example, would be $220 as compared with $200 under ordinary value-added tax treatment.

Under the EEC system, the total tax on a product may be either more or less than would prevail under ordinary value-added tax treatment. The outcome depends on the percentage of the purchase price of farm products that the farmers' business customers are allowed to credit. In the Table 6-4 example, the farmer actually paid the seed seller value-added tax of $60; this is the amount that should ideally be allowed as a credit to the wholesaler. However, in the example, the wholesaler is allowed to credit only $40 against its gross liability. The $20 difference between the amount the wholesaler should ideally have credited and the amount of tax allowed as a credit represents the difference between the total tax collected under the EEC alternative system ($220) and the amount that would be collected under ordinary value-added tax treatment ($200). Thus, under the EEC alternative tax treatment, the total value-added tax imposed on a product

Table 6-4

Illustrative Treatment of Farmers Under a 10 Percent Value-Added Tax

ITEM	SEED SELLERS	FARMER	WHOLESALER	TOTAL
		Assumed facts		
Sales	$600	$1,000	$2,500	$4,100
Less purchased materials:				
From farmers	-	-	-1,000	-1,000
Others	-	-600	-500	-1,100
Equals value added	$600	$ 400	$1,000	$2,000
		(1) Ordinary value-added tax treatment		
Tax due on sales (at 10% rate)	$ 60	$ 100	$ 250	$ 410
Less credit for tax paid on purchases	-	-60	-150	-210
Equals net tax due	$ 60	$ 40	$ 100	$ 200
		(2) Exemption of farmer		
Tax due on sales (at 10% rate)	$ 60	$ 0	$ 250	$ 310
Less credit for tax paid on purchases from others	-	0	-50	-50
Equals net tax due	$ 60	$ 0	$ 200	$ 260
		(3) EEC alternative treatment for farmers		
Tax due on sales (at 10% rate)	$ 60	$ 0	$ 250	$ 310
Less credit for tax paid on purchases:				
Assumed amount paid to farmers	-	-	-40	-40
Other suppliers	-	0	-50	-50
Equals net tax due	$ 60	$ 0	$ 160	$ 220
		(4) Exemption of farmers and zero rating of Major Farm Inputs		
Tax due on sales (at 10% rate)	$ 0	$ 0	$ 250	$ 250
Less credit for tax paid on non-farm purchases	-	-	-50	-50
Equals net tax due	$ 0	$ 0	$ 200	$ 200*

* There would be a small additional tax element from non-zero-rated farm inputs.

is only an approximation of what would happen under ordinary treatment. Only by chance would the value-added tax collected under the EEC system turn out to be the same as would be collected from farmers and their customers under ordinary value-added tax treatment.

In all the EEC countries, farmers may elect to join the standard value-added tax system. If they join the system, their sales are taxed and they are allowed to credit the value-added tax paid on their purchased inputs against their gross value-added tax liability. Many of the large, highly mechanized farms find it to their advantage to be in the regular value-added tax system since they pay more value-added tax on their purchases than they would be allowed as credits under the special system for small farmers. In addition, farms producing goods for direct export must join the standard value-added tax system in order to get refunds for the value-added tax paid on their purchases.

The lower part of Table 6-4 shows the situation with exemption of farmers and zero rating of sales to farmers of major inputs, such as seed. The total tax shown is $200, the same as under ordinary value-added tax treatment. The actual tax may be somewhat higher because of the tax element in the purchases of any non-zero rated farm inputs.

6. **Summary.** There is no ideal solution to the farm problem. The recommended solution would exempt farmers and zero rate the sales to farmers of basic primary farm inputs: livestock and livestock feed, seed, fertilizer, farm machinery, and, probably, fuel--primarily diesel--sold for farm purposes. It should be possible to devise some system to avoid taxing at pre-export stages the very large volume of sales of farm products for export.

IV. Governments and Not-for-Profit Institutions

In designing a value-added tax, questions may arise as to whether the tax should apply to activities of governmental entities and non-profit institutions.

A. Governmental Units

Under any form of sales tax, the treatment of governmental units encounters special issues concerning general policy, administration, competitive equity, and intergovernmental relations.

Most governmental services are provided without a specific charge, and therefore value-added tax cannot apply to the services per se. There are four issues that arise under a value-added tax:

1. Should the tax apply to sales by governments when a charge is made?
2. How should government purchases be treated?
3. Should Federal, state, and local governments be treated in the same fashion?
4. Should government-owned corporations or the equivalent be treated differently from government agencies?

1. **Sales by governments.** In general, the basic rule should be that if the activity is taxable when it is provided by private firms, value-added tax should apply to sales by government units, unless there are compelling reasons to the contrary. Thus, essentially commercial activities of government, such as the sale of electric power by government-owned utilities, alcoholic beverages by state liquor stores, prints by a government art museum, meals in government cafeterias, highway toll roads, and parking garages (but presumably not parking meters), would be subject to tax. Governmental units providing these goods and services would be registered for the value-added tax.

But there are borderline cases. Charges are made for various traditional government activities, such as recording deeds, issuing passports, and licensing household pets. Sales of government documents have a somewhat similar status. There would appear to be little gain from applying the value-added tax to these traditional governmental activities. Another borderline case is the postal system; should value-added tax be applied to postal charges? For parcel post the case seems clear: tax should apply if it does to transport by private firms. While there is no economic reason not to apply a value-added tax to first class and special delivery postal charges as well, there may be some political objection.

Problems would also arise with activities such as garbage collection. In many municipalities, garbage collection is financed out of general tax revenue with no separate charge to the users. But some municipalities do charge separately for the service, and users are charged for all garbage collection provided by private firms. But to apply a value-added tax to either of these charges when garbage disposal financed by general tax revenue would not be subject to the tax raises serious questions of equity and may create economic distortions.

2. **The tax treatment of government purchases.** With regard to the value-added tax treatment of purchases by governmental units, there are three alternatives:

(a) Exempt governmental units. Under this approach, government units would not be registered (except when they are subject to value-added tax on their charges) and would not file value-added tax returns. But they would bear the full burden of the tax applied to their purchases. At the Federal level, there should be no great objection to this, though would be no net revenue gain from collecting the tax on Federal purchases, because the cost of government purchases would increase by the amount of the tax. With exemption, the filing of value-added tax returns by Federal agencies and the issuing of large refunds that would involve only intragovernmental transfers would be avoided.

The issue, however, is quite different with respect to state and local purchases, as exemption would involve a net transfer of resources from sub-Federal governmental units to the Federal government.

There may even be constitutional issues, quite apart from the political ones. Thus, some method must be adopted to remove the value-added tax burden from the purchases of state and local governmental units. There is no objection, incidentally, to applying more lenient treatment to the states and local governments than to the Federal government, though there would be to the reverse.

(b) Zero rate governmental units. This approach would remove the value-added tax burden from the governmental units since they would receive a credit or refund for tax paid on their purchases. But, for both the governmental units and the IRS, it would involve tremendous paperwork in the filing of returns and issuing of refunds to the large number of Federal, state and local government units. Moreover, since applying the tax to Federal government purchases would reflect the true costs of government operations, it does not seem sensible to refund the value-added tax. Thus, there is no need to zero rate the Federal government. With exemption but not zero rating, the tax would still be collected on the purchases by the Federal government, but the administrative and compliance costs associated with filing returns and processing refunds would be avoided.

At the state-local level, however, zero rating would be necessary if another alternative is not used to eliminate the value-added tax on state and local purchases. Zero rating would remove all value-added tax burden, and it would avoid the necessity of the governmental units distinguishing between purchases for the provision of commercial services on which they collect value-added tax and those for other purposes. But it would require every state and local government unit, including the myriad of special districts, to register as a value-added tax taxpayer and file for refunds. However, suppliers would treat sales to government in the same fashion as other sales.

(c) Zero rate the sales to governmental units and exempt the units. This alternative is similar to that suggested for farmers and would also remove the burden of the value-added tax from the governmental units. The suppliers would not apply tax to their sales to governmental units, and would receive credit for value-added tax that has applied to the commodity up to sale to the government. By not registering government units, this approach would avoid a substantial number of tax returns and refund payments. But it would require sellers to distinguish in their sales between governmental and nongovernmental purchasers, as they must do now under most state sales taxes. This would not be a major task for large suppliers such as defense or highway contractors, or suppliers of large quantities of heating oil to a school district. But it would be more difficult for retailers supplying small quantities of goods to local government units. Some loss of tax revenues on otherwise taxable transactions would be inevitable. The question is whether this is a more serious problem than the returns and refund problem that would arise with zero rating of governmental units. This procedure could be applied to the states and localities and not to the Federal Government, but it is the local government level where the greatest danger of leakage of tax revenue may occur.

3. **Government corporations.** Government corporations and similar entities primarily often provide commercial services; the principles outlined above should apply on commercial services whether provided by a governmental agency or a government-owned corporation, such as AMTRAK. Various governments use different systems; the legal status of the entity should not be a relevant consideration.

4. **Summary.** Value-added tax should apply to taxable goods and services, regardless of whether they are publicly or privately provided. There would be little gain from applying the tax to traditional governmental fees and license charges.

Purchases by the Federal government should be subject to value-added taxation to properly reflect the costs of government operations. This would have a net effect on the Federal budget; value-added tax receipts would be higher, but so would appropriations to pay the costs associated with the tax. If it is necessary to allow states and local governments to make purchases on a tax-free basis, two possibilities exist: to zero rate the governmental units or exempt the governmental units and zero rate the sales to them. In many respects the latter is simpler as it avoids excessive filing of returns and subsequent refunds, but it would create some problems for suppliers.

B. Taxation of Nonprofit Institutions

A wide range of nonprofit institutions is not subject to Federal income tax. Decisions must be made as to their treatment under a value-added tax; exclusion from one form of tax does not necessarily warrant exclusion from another; each exclusion from the value-added tax would increase the credibility of other pleas for special treatment. There are three major issues:

1. **Should all nonprofit institutions be treated the same?** Consideration of special treatment should focus not on the nonprofit nature of the institutions, but on the activities they perform. In general, special treatment should be considered only for those nonprofit institutions whose services are considered unsuitable for taxation under a value-added tax, as a matter of social policy. These include hospital, charitable, religious, and educational institutions. There is no justification for special treatment for consumer-buying cooperatives, farm cooperatives, labor unions, farmer and business associations, fraternal and social organizations, and the like. Some of these will make no sales of taxable goods and services and thus will not be registered under the value-added tax, but their purchases would be taxed in the regular manner; those organizations making taxable sales would be registered and subject to tax.

2. **Tax treatment of sales.** As noted in section II on the taxation of services, many services are provided without a charge in the usual sense; one does not pay a charge to attend church and persons receiving charity do not pay a charge for it. Accordingly, a value-added tax cannot, indeed should not, be applied to the services for which no charge is imposed. Some of these institutions, however, may provide

other services for a charge or sell commodities. The most satisfactory general rule is to apply value-added tax to the charge if the tax would apply if the service or commodity were provided by profit-making firms. Thus, a university or research institution selling books or personal computers would be registered and would collect value-added tax on these sales. This would also be true of sales in hospital gift shops and of sales by workshops for the blind. Tuition charges for education and hospital charges would not be taxed on the basis of both economic and social policy considerations.

3. The alternatives on purchases. Because it is not necessary to encourage all forms of activity undertaken by nonprofit institutions, the argument for special treatment of purchases of nonprofit institutions is much weaker than in the case of their sales. If some of the institutions are to receive special treatment for their purchases on social policy grounds, there are several options:

(a) Exemption of the institution. If the institution is exempt, it would not be subject to value-added tax on the services it renders, but it would receive no refund of tax on its purchases. The result would be that the institution would bear the burden of value-added tax on its purchases, but not on its own value added. Thus, there would be little burden on labor intensive types of activities. Under this rule, nonprofit institutions would not be registered, except for incidental activities such as operating a cafeteria for the public; they would receive credit only for the purchases for the registered activity. This would be a source of some problems but it is not insolvable.

(b) Zero rating of the institutions. This would free them from all value-added tax on their purchases and would eliminate the need for distinguishing between purchases for their general functions and for specialized taxable activities. But they would be registered and file returns to obtain refunds; tax would be collected from their suppliers, and in turn refunded to the institutions. The choice of this method vs. exempting should be made on the basis of social policy: is it essential to remove the value-added tax on their purchases, and is this worth the administrative and compliance costs of handling large numbers of returns and refunds which yield no revenue?

(c) Exempt the institutions and zero-rate sales to them. By this means, the institutions would not be registered as value-added tax taxpayers (except on their specialized taxable activities, if any); they would be issued a special institution number as hospital, religious, educational, or charitable organization, enabling them to buy tax free. Not only would all sales to them be free of tax, but the seller would receive credit for tax paid on the purchase of these goods or on their inputs. Thus, all value-added tax burden would be removed from the institutions without the need for their being registered as taxpayers and filing returns. The suppliers, however, would have the troublesome task of distinguishing sales to these institutions (in the same fashion that firms selling for export must identify export sales). Though there might be some abuse of this privilege, the difficult administrative problems of handling the returns from

these institutions, itself subject to some possible abuse, would be avoided. The procedure would be comparable to that used by the states in excluding sales to these institutions and to the treatment suggested for farming in an earlier section.

One further issue relates to the treatment of for-profit institutions in the hospital and education fields. For hospitals the same treatment should be applied to profit and nonprofit institutions; the zero rating would apply to hospitals regardless of the for-profit situation. It would be difficult to do otherwise, since the tax is presumably borne by the users of the service.

4. **Summary.** Special treatment of nonprofit institutions under the value-added tax would give rise to a number of administrative problems and would lessen the generality of the tax. Special treatment should be considered only for those of a religious, charitable, educational, or health care nature; while others are not subject to Federal income tax there is no need to give them special treatment under a value-added tax. For those receiving special treatment, a choice must be made among the three techniques: exempting them, zero rating them, or exempting them and zero rating of sales to them. Only the second and third would remove all value-added tax burden. Zero rating of nonprofit institutions would require registration, filing of returns, and granting of refunds. Zero rating of sales to them would avoid these problems, but would require suppliers to distinguish these sales from others.

V. Housing and Construction

The taxation of housing services is one of the most troublesome aspects of a value-added tax, as is the related issue of taxation of real property construction. Much of the problem arises because a large portion of total housing is owner-occupied, the remainder being rental; complete equality in treating homeowners and tenants is difficult if not impossible to achieve under a value-added tax. The second aspect of the problem is that housing facilities have very long lives compared to other consumption; housing built or acquired in one year will be consumed over a long period of time. A similar timing problem arises with nonhousing construction.

Before these issues are considered, however, the threshold question is: should consumption of housing be subject to a value-added tax? The general answer, as to all consumption spending, is yes, unless there are compelling reasons for not doing so. One reason for not so doing is the importance of housing costs in the family expenditure patterns of the low-income groups. If there is no general system to reduce value-added tax on the poor, such as refundable credits, a convincing argument can be made for attempting to exclude a minimum housing expenditure from tax, just as there would be for zero rating of food. This is not easily accomplished. General exclusion of housing from the tax would favor those persons with relatively high preferences for housing and provide an artificial incentive to increase housing consumption relative to that of other goods. The base of the

tax would be reduced materially, requiring higher rates to raise an equivalent amount of revenue.

A. Housing: Homeowner versus Tenant

If the principle is accepted that housing expenditures should be subject to at least some value-added tax, the most difficult issue to resolve is the provision of reasonable equality of treatment between homeowner and tenant, a problem aggravated by the long lives of housing facilities. The failure to provide equality of treatment would encourage the favored type--almost certainly homeownership--and would discriminate against families that could not or did not wish to own their homes.

With rental housing, there is no major problem in applying a value-added tax; the building owner would apply the value-added tax to the rental charge and would in turn receive credit for value-added tax paid on the building and all other purchases of produced goods necessary to provide the rental facilities. (The timing problem of crediting the tax on the purchase of the building is discussed below). Under this approach, all lessors would be registered and would file value-added tax returns. The only operational problem would arise with persons renting only one or two houses, or rooms in their own homes; it would be difficult to ensure that all such persons registered for value-added tax purposes, compliance would be a burden, and delinquency in the filing of periodic returns would probably be high.

With respect to owner-occupied housing, each home or condominium unit owner could be required to pay value-added tax periodically on the imputed rental value of the home or unit. This, however, would give rise to several problems. First, it would require that each homeowner be registered for the value-added tax, thus sharply increasing the number of registered units and creating significant administration and compliance costs in handling returns and delinquencies. A second problem is that of determining the imputed rent, or what the house would rent for if it were rented in an open market transaction, net of expenses. This would be a notional value; but notional, as distinct from market, prices are always troublesome in any form of sales tax. Third, historically there has been strong resistance to including imputed rent in income for income tax purposes; there also would be restrained enthusiasm to doing so under a value-added tax. If imputed rent were taxed, homeowners would be required, in effect, to include the imputed rental value as an element in income (even if was not taxable for income tax purposes) and simultaneously treat it as a consumption expenditure. There would be public resistance to paying value-added tax on an element which does not appear as or arise from a monetary transaction. Because of these problems, it would not be feasible to include imputed rent on owner occupied housing within the scope of a value-added tax. Therefore, rent paid on rental housing should not be included either, for reasons of both equity and economic efficiency.

1. Taxation of purchases of new residential housing. One alternative would be to tax persons on the purchase of newly-constructed houses less the value of the land, or the equivalent, tax the entire contract price when a person enters into a contract for the construction of a new home. This would require that all general contractors be registered for value-added tax as well as subcontractors and speculative builders. The tax would apply to all new housing facilities whether purchased by landlords or occupiers. This approach would provide equity between homeowners and tenants in a rough way, but it is not without its problems.

It would require the registration of all general contractors, a group that the states have found to be difficult to control for sales tax purposes. Many contractors are small concerns, which may build only one or two houses a year. Subcontractors would be less of a problem since many are also wholesalers or retailers of building materials and would be registered anyway. With this alternative, tax would apply on the charges made by the subcontractors for materials and services provided to the general contractors; the latter would receive a credit for this tax against their own tax liability. Exclusion of the value of the land is troublesome, but if it is not excluded, the land would be sold separately. Taxation of land, per se, is not appropriate under a consumption tax; the purchase of land, from the standpoint of the economy, is not a consumption activity.

The more serious problem is that the tax would apply only to the initial sales of new construction, plus repair and alteration work. Persons already owning their homes at the time the tax was introduced would escape value-added tax on their housing expenditure, except for repairs and maintenance. The sale and rental value of existing houses would tend to rise, because new houses would be more expensive, creating a windfall gain for the present owners.

There also is a timing problem. Though a house may be used for 75 years, tax would be borne when the new house is acquired. On other expenditures, the purchased item will be used immediately or with few exceptions over a relatively short period. But with housing, a large sum of tax would be paid for consumption to be spread out over decades. The consequent increase in the cost of housing would undoubtedly reduce somewhat the construction of new housing, since many families can afford only a certain monthly payment for the purchase of homes.

2. Taxation only of materials. A second alternative, which parallels the practice in most states under the retail sales taxes, would be to tax only the materials and other produced inputs going into real property construction. General contractors would, in effect, be exempt. The general contractors would not be registered (unless they also were dealers in materials) and they would not file value-added tax returns. If they were registered because they were also dealers for construction materials, they would file returns and charge tax only for their dealership activity. Tax would not apply to sales of new housing by general contractors; nor would they receive a credit

for value-added tax paid on their purchases of materials. Thus, tax would be reflected in their contract prices. Subcontractors would typically be registered because they usually are dealers for construction materials. Subcontractors would charge value-added tax on their sales to general contractors and would receive a credit for tax paid on their purchases. The general contractor would not receive credit for tax paid on purchases from the subcontractor.

The principal merit of this approach is that, since it parallels state practice, the building industry would be familiar with it. It also would reduce the tax burden on housing, compared to the alternative of taxing the full sale price (excluding land) of newly-constructed housing. This alternative, however, would encounter some operational problems. If a different rule were used for nonhousing construction, contractors would have to segregate the two types of contract work. This would be complicated by the fact that some buildings are built for both housing and commercial use.

B. Commercial (Nonhousing) Construction

The value-added tax should apply to the contract price of nonhousing commercial construction. Under this approach, the contractor would apply value-added tax to the contract price and would receive a credit for tax paid on materials. A building owner renting space to commercial tenants would apply value-added tax to the rental charges, and would receive a credit for tax paid on the purchase of the building. Or, a manufacturer or distributor constructing a new building would pay tax on the contract price, or on the materials if it did the construction with its own employees, and would receive a credit for this tax against the tax due on its sales.

There may be a timing problem of some consequence. The manufacturer who contracts for the construction of a factory building would bear a value-added tax on the full purchase of the building. If the firm does its own construction, it would pay tax only on the materials purchased, not on the labor used to erect the building. In both instances, it would receive credit for the tax paid on purchases against value-added tax due on sales, but the timing of the payment and credit may be different and many affect the choice between self-contracting and the use of an outside contractor.

If general contractors are not registered, even for work on business construction, and merely pay tax on their materials for business construction, as well as for housing construction, the chain of tax and credits would be broken, and the firm for which the construction is undertaken could not receive a credit for tax on the construction materials. This would create a strong incentive for self-construction, or for the purchase of the materials by the firm for which the building is being erected. An alternative would be to allow the registered firm acquiring the building a credit equal to a certain percentage of the contract price as representing the value-added tax

on materials, but the amount would be an average and somewhat arbitrary. This would be similar to the EEC treatment of farmers, discussed above.

It is not impossible to use different rules for residential and nonresidential construction, but this would require contractors doing both types of work to keep distinct records, as they would receive credit for tax paid on materials only for the nonhousing construction. If housing construction were freed entirely from value-added tax, this would greatly aggravate the problem of distinguishing between housing and nonhousing construction, and between housing construction and taxable repair activities.

With all approaches to the problem, there is one special difficulty: that of distinguishing between real property construction on the one hand and installation of "fixtures," such as stoves, carpeting, and drapes, on the other. Presumably, the tax should apply to the full sale price of "fixtures" such as stoves, and not the contractor's purchase price, as with materials. This is a troublesome issue, but the states have developed workable rules, and the value-added tax could use the same ones.

C. European Experience

Under the Sixth Directive of the EEC, the leasing of immovable property is tax exempt. Most countries follow the directive and do not levy the value-added tax on residential rents. However, the value-added tax may be imposed on rental payments of taxable entities if they opt for it. A restaurant, for example, may wish to be taxed on its rent so that it may credit the value-added tax against its gross value-added tax liability. Otherwise, the restaurant's customers would be subject to taxation both on the restaurant's meals and on the non-creditable tax borne by the restaurant on the taxable purchases of its lessor.

European experience shows that there are no easy solutions to the problems of applying the value-added tax on housing. The European regulations that are designed to cope with these problems are so complex that it is difficult to generalize about their provisions. The practice in European countries using the value-added tax varies considerably. In Great Britain, sales of new homes are zero rated while such sales are taxed fully in Belgium and the Netherlands. The practices in most of the other EEC countries appear to fall somewhere between the two extremes of fully taxed or totally free of tax.

For the most part, neither the sale nor the leasing of land is subject to the value-added tax in Europe, although France imposes the value-added tax on the transfer of building sites. On the other hand, the value-added tax is levied on work done to improve the land, such as project engineering, leveling, construction and on alteration, repairs, or maintenance of existing buildings.

D. Summary

There is no ideal solution to the problem of taxing housing and real property construction. Equitable application of value-added tax to rents from housing is clearly impossible, in view of the fact that there is no possibility of tax being applied to the imputed rental value of owner-occupied housing. This is a major area in which universal application of the value-added tax is simply not feasible. The second best alternative is to apply the tax to the sale price or total contract figure on new housing construction, or, following state practice, to the cost of materials to the contractors. The choice between these two must be made primarily on the basis of whether taxing sales of new housing is considered to be too harsh. Application of the value-added tax to the full contract price would allow the same policy to be used for nonhousing construction.

VI. Taxation of Used Durable Goods

The value-added tax treatment of sales of used goods, both consumption goods and business assets, is closely related to the issue of the taxation of housing.

A. Consumption Goods

Purchases of used consumer goods constitute a significant element in the annual volume of consumption. In a sense, the sale of most homes constitutes a sale of "used" goods; clearly these would not be taxed, in part, because most sales are made between individuals who would not be registered for value-added tax. Motor vehicles are the other major category, but there are substantial sales of used furniture and other items as well.

While the purchase of used goods constitutes a consumption expenditure from the standpoint of the buyer, there are several reasons for not fully applying the value-added tax on such transactions:

1. After the tax has been in effect for a few years, the sale price of used consumer goods would reflect the value-added tax paid on the original purchase, and thus the purchaser of the used good would share a portion of the tax borne by the initial purchaser. Imposing value-added tax a second time when the item is sold as a used good would constitute a double tax.

2. In terms of the economy, no new consumption activity is involved in the purchase of used goods; except for the value added by the used goods dealers, resources are not being used for the production of consumption goods. A part of the existing stock of durable consumption goods is simply being shifted from some persons to others.

3. Many of the transactions in used goods are between nonregistered individuals, including garage sales and "flea market"

sales that would be difficult to control. Attempts to fully tax sales of used goods by registered firms would drive even more transactions to flea-market types of arrangements.

4. On sales of used goods by registered firms, there would be no separate tax element on the purchases of those goods for which to take value-added tax credit.

In light of the above, one general rule could be: do not apply value-added tax to sales of used goods. But this approach is not without problems:

(a) For the first few years after enactment of the tax, the used goods that are sold would not have been taxed on the original purchase. Instead, as in the case of owners of existing housing, the owners would enjoy a windfall gain as the prices of used goods would rise, reflecting higher prices on new goods. But this is an inevitable transitional problem and is virtually impossible to resolve without serious complications.

(b) Used goods sometimes sell for a price many times higher than the original purchase price. This is particularly true of antique automobiles. A car that cost $700 in 1925 may sell for $50,000 today. The same is true of other antiques. But there is no suitable way of adjusting between these and other used goods.

(c) A further problem is that sellers of both used and new goods must segregate sales between the two classes if used goods are not taxed. This would not be a problem for motor vehicle dealers selling new and used cars, but this segregation may not be done accurately by many repair shops handling both repair and sale of new and used items, nor by second-hand stores, which often sell new merchandise as well as old.

(d) If used goods were not taxed, firms selling only used goods would not be registered (technically, they would be exempted). Thus, value-added tax would apply to their inputs and thus to a portion of their value added. But, as noted, most used goods dealers sell some new goods as well. They are therefore registered. To attempt to require them to segregate inputs between new and used goods (electricity, for example) would be impossible except in some very arbitrary way. Yet, to allow them to obtain full credit for tax paid on all inputs against the tax due on their sales of new goods would give them a competitive advantage over firms that handled only used goods, unless the latter were allowed to register voluntarily.

5. A more serious problem is that the used goods dealers do add value to the goods they handle. The extreme case is that of motor vehicle dealers who often perform substantial work on the vehicles before reselling them. But if the selling price is taxable, no tax credit on the purchase would be available to the dealer. Yet to free

the sale completely from value-added tax would allow current value added and consumption expenditures to escape taxation. There are two alternatives to this problem:

(a) Disallow the credit for value-added tax paid on the inputs for the repair work. This would allow the labor, the chief element in many repair jobs, to escape taxation, but at least the parts would be taxed. But this would require the dealer to segregate inputs between those used for repair of goods for resale and those used in direct repair work for customers. This would be a major complication.

(b) Allow the dealer to assume that 10 percent (assuming a 10 percent value-added tax rate) of the purchase price of the used car or other used goods (the trade-in allowance when the good was obtained as a trade-in on the purchase of another item) constitutes the value-added tax element on the purchase, and to take credit for this against the tax due on the sales, along with tax on the other inputs. This is somewhat arbitrary, but would appear to be the most satisfactory approach.

Quite apart from repair, all second-hand goods dealers add value; the amounts are typically smaller, of course, where no repair work is done. This suggests the desirability of registering all firms selling used goods (not individuals selling casually), requiring them to pay value-added tax on their sales, and allowing them to take credit for tax paid on their purchases under the assumption that 10 percent of their purchase prices consists of the value-added tax element. In a rough way, this reaches the value added they have created. How they bill their customers for the tax would be left to the firms.

6. Trade-in allowances. A related question is the tax status of trade in allowances, which are, of course, highly important in the sale of consumer durables. Does value-added tax apply to the total sale price, or the net price after deduction of trade in allowances? The actual consumption expenditure involved is the net price after trade-in allowance, not the gross; the buyer has not completely utilized all of the traded-in article, on which he has paid value-added tax, and to pay tax on the gross price would involve paying value-added tax twice on the same sum. From the standpoint of the seller, likewise, the amount received on the sale is the price actually paid, that is, net after trade-in. The dealer has also received a used good for which he has "paid," essentially the amount of the trade-in allowance. If eventually he sells the traded-in good, under the rule proposed above he would apply tax to the selling price and then deduct 10 percent of the amount of the trade-in allowance granted as reflecting the value-added tax element in the purchase.

7. Summary. There is no ideal solution to the used goods problem. There is no possibility of applying value-added tax to transactions between individuals without hopelessly complicating the tax and increasing tax administration and compliance costs. General application of the tax to the full selling price of used goods would be contrary to the principle of a consumption tax, assuming that prices

of used goods reflect value-added tax paid on the original purchase. Full taxation of used goods would likely make the tax more regressive because of the importance of used goods in the expenditure patterns of the poor.

It is, however, undesirable to lose the revenue from the substantial labor performed on used cars before their resale and on other elements of value added by used goods dealers. Thus, the most workable solution would be to register all used goods dealers, and allow all sellers of used goods to assume that 10 percent (if the tax rate is 10 percent) of the price of acquiring the used goods represents the value-added tax in the purchase price. Used good dealers would be allowed to credit this tax against the tax due on their sales.

B. Sales of Used Business Assets

A related question is whether there are problems with the sale of used business assets between registered firms that would require special treatment under a value-added tax, comparable to those with used consumer durables.

Generally, the answer is no. For example, suppose that a business firm buys a turret lathe in 1988, paying value-added tax to its supplier and crediting the amount of the tax on the purchase of the lathe against the tax due on its sales. In 1994, the firm which purchased the lathe decides to sell the lathe to replace it with a more modern one. It sells the used lathe to a new small manufacturer. The seller of the used lathe applies value-added tax, as on any sale. The business purchaser of the lathe, in turn, receives credit for this tax against the tax due on its sales during the period. On both the original and the subsequent sale, the tax and credit procedure serves to, in effect, free the lathe of value-added tax.

Suppose, instead, that on the subsequent sale the lathe is sold to someone who is not registered for value-added tax, for example a farmer or a hobbyist. In this case, the lathe has now become a consumption good. The seller would apply value-added tax, as it does to all sales, and collect it from the customer. The customer would not receive credit for the tax since it is not a registered firm. Accordingly, no distinction needs to be made by business firms between the sale of capital assets and sales from inventory; such distinctions are usually required under retail sales taxes. The sale of used capital assets can be treated in the same fashion as any other sale by registered firms under a value-added tax; there is no necessity of special treatment.

VII. Tax Treatment of Fringe Benefits

Fringe benefits, which are essentially substitutes for monetary compensation, have grown in importance in recent years because many are free of the income tax. In one sense, they constitute simultaneous earning of income and of consumption expenditures, which may be regarded as being made either by the firm or by the recipients.

Value-added tax should be paid on fringe benefits if the benefits are taxable when purchased in the usual fashion. The questions are: by whom should the tax be paid and on what value should it be based?

A. Forms of Fringe Benefits

Fringe benefits take a variety of forms, and precise uniform treatment for value-added tax purposes is impossible.

1. The employer may purchase commodities or services for the employees that would be taxable if purchased directly by the employees. Thus, the employer may purchase a gold watch for a retiring employee, pay for dinners for executives or other employees, buy television sets to give to sales persons exceeding their quotas, or provide tours to Hawaii for employees and their spouses.

There are two general approaches to ensuring that value-added tax applies in this case. The first is to require the firm to include the sale value of the benefits in its own sales and to pay value-added tax on that value. It would, of course, be entitled to a credit for tax paid on the purchases related to the benefits. The second is to deny the firm a credit for value-added tax paid on the purchase of the goods provided as fringe benefits or on the inputs used by the firm to produce the benefits. This second approach, which is the simpler method, in effect, would treat the firm as the consumer of the fringe benefits. Whether the value-added tax should be charged to the recipient of the benefits is a separate issue; it is not a matter of tax policy, but an internal matter between the firm and its employees. Generally, the firm would not charge the recipient for the tax on the benefits. If the employees had been given money instead, they might not have acquired the goods at all and charging the employee for the tax would be contrary to the general intent of many fringe benefits.

2. The second situation is that in which the firm provides to its executives or other employees, either free or at substantial discount, commodities which the firm produces. In principle, the same rule should be followed as in (1) above: the firm should not be allowed a credit for value-added tax paid on the inputs used to produce the commodities. But disallowance is virtually impossible, as the inputs cannot be effectively segregated to isolate those that are used to produce the items that are provided as fringe benefits. This is particularly true of the cost of capital equipment and buildings used in the production process. In this instance, the best solution would appear to be the one that is used with retail sales taxes: the firm must include in taxable sales, at their commercial sales value, the value of the goods given to employees or used by the proprietors. Again, whether the employer withholds this sum from the employee's pay is essentially an internal matter between the employer and employee.

Suppose, however, that the firm does not give the items to employees, but sells them at an employee discount. This is a very common practice, but so are numerous other discounts to the elderly, to members of various organizations, and the like. It would not be

worthwhile to attempt to adjust the taxable price upward by the amount of this discount; value-added tax should apply--and presumably be collected from the employee--on the basis of the actual selling price, as long as the discount does not exceed a certain percentage (to prevent the avoidance of value-added tax by selling at a 99 percent discount).

3. A third case, related to the second, is that in which the firm provides certain services free or at substantial discount to its employees and the services are of such a nature that providing them to the employees does not require any additional inputs. The principal case is free plane trips for airline employees, available only when space is not purchased by customers. Since application of the tax in this instances would reduce the use of this service, though it has no economic cost, value-added tax should not be imposed.

4. A final case is that in which the firm provides various goods for the use of some of its employees, typically its executives, such as company cars. Workers may be provided lounges with television sets. It is very difficult to draw the line between the provision of vehicles as a necessary element in the operation of the business and the provision of them as consumption goods. One solution, when the firm provides automobiles or other goods (e.g., television sets, personal computers) for the exclusive personal use of particular employees would be to require the firm to include in its taxable receipts the sale price or rental value of the items.

Since automobiles are the chief category involved, the alternative is to deny the credit for all tax arising from purchase of automobiles, as is done in some EEC countries. This may be somewhat drastic, as many firms must of necessity provide cars for employees' use in the business operation (telephone companies, for example). A difficult delineation is that between automobiles and pickup trucks and related vehicles. But general denial of credit on automobiles should be considered.

B. Summary

As under the income tax, fringe benefits create difficult problems with a value-added tax. The following, necessarily imperfect, solutions are recommended:

1. In principle, if a particular commodity or service that is ordinarily taxable is provided an employee and if the employee would purchase the item if given money income instead, value-added tax should apply. Most instances, however, in which fringe benefits are provided are not this straightforward.

2. When goods are purchased by a firm for the specific purpose of giving them to employees, the firm would be denied credit for tax paid on the purchases.

3. When a firm gives goods that it produces to its employees, it would apply value-added tax at the typical price at which it sells these goods. Whether it bills the employee for the tax is an internal matter for the firms.

4. When the firm sells at an employee discount to its employees, the tax would apply to the discounted price, as long as the discount does not exceed a specified percentage.

5. When a firm provides a service to an employee that requires no additional inputs, value-added tax would not apply.

6. There is merit in disallowing the credit for value-added tax paid by a firm for meals and drinks under all circumstances. The same policy should be considered for automobiles.